

cable activities⁴⁷⁰ and non-cable activities.⁴⁷¹ These allocations shall be used for cost-of-service showings and for allocating external costs.⁴⁷² For the purpose of allocating their costs and revenues among the service cost categories and the equipment basket in cost-of-service proceedings, cable operators shall use

per-program basis; or

(3) A combination of multiple channels of pay-per-channel or pay-per-program video programming offered on a multiplexed or time-shifted basis so long as the combined service:

- (i) Consists of commonly-identified video programming; and
- (ii) Is not bundled with any regulated tier of service.

By this Report and Order, we require that the cable programming services cost category include only allowable costs as defined by §§ 76.922(e) through 76.922(g) of our new rules.

⁴⁶⁹ Nonregulated cable programming service is video programming that is not carried on either the basic service tier or a cable programming service tier. It includes video programming that is offered on a pay-per-channel basis, on a pay-per-program basis, or as any combination of multiple channels of pay-per-channel or pay-per-program video programming offered on a multiplexed or time-shifted basis as long as the combined service consists of commonly-identified video programming and is not bundled with any regulated tier of service.

⁴⁷⁰ Other cable activities include all cable services that are not included in the basic service, cable programming services, or nonregulated cable programming services categories. Other cable activities includes leased commercial access, billing and collection services, studio and nonregulated equipment engineering and rental services, sale of nonregulated equipment, and maintenance of nonregulated equipment sold to customers.

⁴⁷¹ The non-cable service cost category shall include all activities of a cable operator that are not related to the provision of cable services.

⁴⁷² See part VII. infra regarding external costs.

FCC Form 1220 or FCC Form 1225.⁴⁷³

239. We also require that, to the extent possible, all costs be directly assigned among the equipment basket and the service cost categories.⁴⁷⁴ In making this determination, we are modifying the existing requirement that, with a few exceptions, cost categories identified at the franchise level be generally allocated to the basic tier based on the ratio of channels in the basic tier to the total number of channels offered in the franchise area and that costs allocated to each tier of cable programming be based on the ratio of channels in each cable programming services tier to the total number of channels offered in the franchise area.⁴⁷⁵ We find that when direct assignment is possible, it is preferable to a standard allocator because, while cost allocation provides an estimate of the origination of certain costs, direct assignment more accurately reflects cost causality.

240. For those costs that cannot be directly assigned, cable operators shall allocate such costs among the service cost categories and the equipment basket through methodologies that are consistent with the procedures in Section 76.924(f)(5) of our rules.⁴⁷⁶ The Commission and local franchising authorities will

⁴⁷³ Small cable system operators shall use FCC Form 1225. All other cable system operators shall use FCC Form 1220.

⁴⁷⁴ Direct assignment applies when costs are incurred exclusively to support the equipment basket or a specific service cost category. For example, most programming charges from program suppliers relate to specific programming. Those charges should, therefore, be directly assigned to the tier on which the programming is offered.

⁴⁷⁵ As stated below, however, where direct assignment is not possible, cable operators shall propose cost allocation methodologies that are consistent with § 76.924(f)(5) of the Commission's rules. We note that the allocation procedures required in § 76.924(f)(5) may, under certain circumstances, permit allocations on a per channel basis.

⁴⁷⁶ These procedures require that, when direct assignment is not possible, operators must first attempt to allocate such costs through direct analysis of the origin of the costs. 47 C.F.R. § 76.924(f)(5)(i). Direct analysis could be applied effectively where records are maintained in such a manner that analytical procedures would allow for a determination of cost causality. For example, wages expense for equipment installers may not be accounted for on the basis of activities or functions, but the

review the allocators proposed by cable operators on a case-by-case basis and determine whether the allocators achieve reasonable results.⁴⁷⁷ We agree with those commenters who suggest that we should be cautious at this time in adopting specific allocators or rigid cost allocation schemes.⁴⁷⁸

underlying payroll records or a time study may indicate the activities on which the installers spent their time. Such analysis, therefore, may allow for allocation of installers' wages expense on the basis of labor hours.

In addition, our rules continue to require that, where direct analysis is not possible, operators must attempt to establish cost-causative linkage to other costs directly assigned or allocated by direct analysis. 47 C.F.R. § 76.924(f)(5)(ii). In this case, for example, the costs associated with the vehicles, tools and equipment used only by the installers might appropriately be linked to the installers' activities or functions, and allocated on the basis of the installers' labor hours. Costs associated with labor and equipment that support the installers and other groups might be allocated on the basis of the groups' collective labor hours.

Finally, where no direct or indirect linkage can be made, our rules continue to require operators to allocate on the basis of the totals of all costs directly assigned and allocated using direct analysis and indirect linkage. 47 C.F.R. § 76.924(f)(5)(iii). Thus, the residual amounts that cannot be directly assigned or allocated by direct analysis or indirect linkage shall be allocated to each category based on the ratio of all other costs assigned and allocated to the category over the total of all costs directly assigned and allocated by direct analysis and by indirect linkage.

⁴⁷⁷ It should be noted that there is substantial support for this approach in the record as numerous commenters recommended that cable operators be allowed to support their allocation methods on a case-by-case basis. See, e.g., Cablevision Systems Comments at 37-38, 51-54; Continental Comments at 77-81; TCI Comments 51-56; COA Comments at 87-91; Georgia Cable Comments at 34; Medium Operators Comments at 25-28; NCTA Comments at 27-29; Arthur Andersen Comments at 35-36.

⁴⁷⁸ See, e.g., NCTA Comments at 27-29; TCI Comments at 51-56. We do not agree, therefore, with CFA's recommendation that we use a tier neutral allocator on the basis of channels as a starting point. CFA Comments at 6. We believe that it is far

241. For the purpose of establishing costs at the franchise level, we will maintain the current requirement that cable operators allocate costs that were identified at higher levels to the franchise level on the ratio of the total number of subscribers at the franchise level to the total number of subscribers served at the higher level.⁴⁷⁹ We amend our rules, however, to specify the particular procedures that must be followed for allocating costs to the franchise level. First, recoverable costs that have been aggregated at the highest organizational level at which costs have been identified shall be allocated to the next (lower) organizational level at which recoverable costs have been identified on the basis of the ratio of the total number of subscribers served at the lower level to the total number of subscribers served at the higher level.⁴⁸⁰ Second, this procedure shall be repeated at every organizational level at which recoverable costs have been identified until all costs have been allocated to the franchise level.⁴⁸¹

VII. Accounting and Cost Allocation Requirements for
External Costs

i. Background

242. Our current accounting and cost allocation rules⁴⁸² apply to cable operators seeking adjustments for changes in their external costs⁴⁸³ as well as to cable operators that elect cost-

better policy to use a flexible approach to cost allocation as a starting point. If the need arises, we can consider the adoption of specific allocators after we have developed further knowledge and expertise under a flexible approach.

⁴⁷⁹ Section 924(e)(1) currently provides that "[f]or the purposes of establishing expenses at the franchise level, cable operators shall allocate expenses and revenues aggregated at higher levels to the franchise level based on the ratio of the total number of subscribers served at the franchise level to the total number of subscribers served at the higher level." 47 C.F.R. § 924(e)(1).

⁴⁸⁰ See Section 922(g)(1).

⁴⁸¹ See Section 922(g)(3).

⁴⁸² See 47 C.F.R. § 76.924.

⁴⁸³ External costs are categories of costs that cable operators may pass through to subscribers without a cost-of-service under our price cap rules. Such costs include

of-service regulation. These rules also contain specific accounting and cost allocation requirements for certain external costs. First, the following external costs must be identified at the franchise level: franchise requirements, franchise fees, local taxes, and local programming. Second, costs of programming and retransmission consent fees must be allocated to the tier on which the programming or broadcast signal is offered. Third, franchise fees must be allocated among the programming service tiers, the equipment basket, and subscribers, in a manner that is most consistent with the methodology of the assessment of the franchise fees by local authorities. Fourth, the costs of public, educational, and governmental access must be directly assigned to the basic service tier where possible.

In the Notice, we sought comment on whether any proposals for changes to the accounting and cost allocation requirements applicable in cost-of-service proceedings should be also applied to external costs.⁴⁸⁴

ii. Comments

243. BellSouth argues that the allocation requirements outlined in the Notice should be extended to external costs.⁴⁸⁵ Georgia Cable opposes applying the proposed accounting and cost allocation requirements to the development of external costs on the grounds that these costs are specific to the franchise or system.⁴⁸⁶ New Jersey, however, urges that the basic cost-of-service principles be applied uniformly to all costs, including external costs in cost-of-service filings.⁴⁸⁷

iii. Discussion

244. We believe that franchising authorities and this Commission must be able to ascertain readily the bases for proposed external cost adjustments in order to be able to

retransmission consent fees, other programming costs, taxes, franchise fees, and costs of other franchise requirements. See 47 C.F.R. § 76.922(d)(2).

⁴⁸⁴ See Notice at ¶¶ 57-65. For a discussion of these proposals, see part VI. supra.

⁴⁸⁵ BellSouth Comments at 24.

⁴⁸⁶ Georgia Cable Comments at 41 (aggregating or averaging external costs would be both unnecessary and burdensome).

⁴⁸⁷ New Jersey Comments at 12.

effectively implement rate regulation of cable service. We will, therefore, apply to external cost calculations the changes to the accounting and cost allocation rules that we adopt in this Report and Order.⁴⁸⁸ Thus, we will continue to require that the following external costs be identified at the franchise level: franchise requirements, franchise fees, local taxes and local programming. For all other external costs, we will continue to require that cable operators identify such costs at the franchise, system, regional and/or company level, depending upon the organizational level at which they identified costs for accounting purposes as of April 3, 1993. These costs shall be identified on FCC Form 1210 and on our cost of service forms. Moreover, after external costs have been identified at the appropriate organizational level(s), cable operators shall allocate such costs among the service cost categories and the equipment basket in the manner specified for cost-of-service showings.

245. With respect to the specific requirements for allocating certain external costs, we will continue to require that the costs of programming and retransmission consent be allocated to the service cost category on which the signal or programming is offered.⁴⁸⁹ We also will continue to require that the costs of public, educational, and governmental access channels carried on the basic tier be directly assigned to basic service cost category where possible.

246. We will modify, however, the allocation requirements for franchise fees. Under the current rule, "franchise fees

⁴⁸⁸ See parts V. and VI. supra. These requirements include use of the summary accounting list adopted here, and allocation to the specified categories. In the Further Notice, we are seeking comment on whether we should require cable operators that seek an adjustment for external costs to comply with the uniform accounting system that we are proposing here for cable operators that elect cost-of-service regulation.

⁴⁸⁹ In light of our decision to adopt service cost categories, we have replaced the phrase "tier on which the programming or broadcast signal at issue is offered" with the phrase "service cost category in which the programming or broadcast signal at issue is offered." See Section 76.924(f)(1) (emphasis added). We find that this minor modification will have no practical effect on the application of this rule because the basic tier is equivalent to the basic service cost category and the cable programming service cost category contains subcategories representing each tier of programming in this category.

shall be allocated among equipment and installations, program service tiers and subscribers in a manner that is most consistent with the methodology of assessment of franchise fees by local authorities."⁴⁹⁰ We find that while the franchise fee should be allocated among the equipment basket and the service cost categories as the rules currently require, the rules should not list subscribers as a category in which such costs should be allocated. We find that the equipment basket and the service cost categories are the only appropriate categories for allocation purposes. It should also be noted we already require that the cost of franchise fees be identified at the franchise level.

247. We also shall modify existing rules to require that, to the extent possible, all external costs be directly assigned among the service cost categories.⁴⁹¹ For those external costs that cannot be directly assigned, we require that cable operators propose specific allocators that reasonably allocate costs among the service cost categories and the equipment basket.⁴⁹²

248. For the purpose of establishing external costs at the franchise level, we will retain the current requirement that cable operators allocate costs that were identified at higher levels to the franchise level on the ratio of the total number of subscribers at the franchise level to the total number of subscribers served at the higher level. We are amending our rules, however, to specify the particular procedures that must be followed for allocating costs to the franchise level⁴⁹³ and these procedures shall apply to cable operators seeking adjustments to external costs as well as operators electing cost of service regulation.

VIII. Affiliate Transactions

⁴⁹⁰ Consistent with our treatment of Section 76.924(f)(1), we have replaced the phrase "program service tiers" with the phrase "service cost categories." See Section 76.924(f)(2).

⁴⁹¹ As noted above, we find that when direct assignment is possible, it is preferable to a standard allocator because it is simpler to apply and it more accurately reflects cost causality.

⁴⁹² The Commission and franchising authorities shall review the allocators proposed by cable operators on a case-by-case basis and determine whether the allocators achieve reasonable results.

⁴⁹³ See part VI, supra.

i. Notice

249. In the Notice, we stated that we would adopt rules to prevent cable operators from imposing the costs of nonregulated activities on regulated cable subscribers through improper cross-subsidization.⁴⁹⁴ We proposed that these rules include rules for valuing transactions between regulated and nonregulated portions of cable systems, and we invited comment on specific valuation methods. In particular, we invited comment on whether we should require cable operators to record affiliate transactions at prevailing company prices offered in the marketplace to third parties, whenever the supplying affiliate has established such prices. We also invited comment on whether we should require cable operators to record each affiliate transaction at the higher of net book cost and estimated fair market value when the regulated cable system is the seller, and at the lower of net book cost and estimated fair market value when the regulated cable system is the buyer.

250. We proposed that the valuation methods we adopt for affiliate transactions govern the amounts cable operators may include in rates based on cost-of-service showings.⁴⁹⁵ In addition, we tentatively concluded that those methods should apply to the programming transactions of cable operators that do not elect cost-of-service ratemaking. We noted that, in establishing our benchmark methodology, we had limited the pass-through of affiliate programming charges to no more than inflation. We sought comment on whether we should employ the affiliate transactions requirements we adopt in this proceeding instead of, or as alternatives to, that inflation-based limitation.⁴⁹⁶

251. We further proposed in the Notice to define affiliate as including any entity having a five percent or greater ownership interest in the cable company.⁴⁹⁷ We proposed to include within the scope of our affiliate transaction rules those transactions that occur between regulated and nonregulated

⁴⁹⁴ Notice at ¶ 67-69.

⁴⁹⁵ Id. at ¶ 67.

⁴⁹⁶ Id. at n.70.

⁴⁹⁷ Id. at n.67. In the Rate Order, we adopted a five percent threshold in defining affiliate for purposes of determining the extent to which cable operators could pass programming charges through to ratepayers. 8 FCC Rcd at 5788, n.601.

portions of the same cable company as well as transactions between separate companies.

252. Subsequently, in the First Reconsideration Order in MM Docket No. 92-266, we modified our external cost requirements to permit cable operators to pass through as external costs the costs of affiliated programming that exceed inflation as long as the prices charged the affiliate reflect either prevailing company prices offered in the marketplace to third parties (where the affiliated program supplier has established such prices) or the fair market value of such programming.⁴⁹⁸ We stated, however, that we would further examine and refine our treatment of affiliated programming costs for external cost purposes in this proceeding.

ii. Comments

253. Cable operators generally maintain that they should be allowed to record purchases at the prices at which the providing affiliate sells to third parties. TCI observes that the Commission has allowed telephone companies to record affiliate transactions at such prevailing company prices. TCI states that similar treatment should be accorded cable companies because all affiliated programmers offer and sell their products to third parties.⁴⁹⁹ Cablevision Industries and Viacom oppose the imposition of affiliate transaction rules and argue that there is no history of abuse in this area.⁵⁰⁰ Small Cities suggests that the Commission allow management fees between cable operators and affiliates where the amounts charged can be shown to be customary and reasonable for transactions between third parties at the time

⁴⁹⁸ Implementation of Sections of the Cable Television Consumer Protection and Competition Act of 1992, First Order on Reconsideration, 58 Fed. Reg. 43853 (Sept. 2, 1993) (First Reconsideration).

⁴⁹⁹ TCI Comments at 58-59.

⁵⁰⁰ Cablevision Industries Comments at 57-60; Viacom Comments at 57-60. These commenters agree, however, that if the Commission does impose such rules, cable operators should be allowed to record purchases at prevailing company prices. Absent such a methodology, they contend, cable operators should be allowed to provide evidence as to market prices by submitting the prices paid by an entity for the same or similar service or product from an independent supplier.

of the agreement.⁵⁰¹

254. Cablevision Industries and Viacom also maintain that the Commission already resolved the valuation issue in the First Reconsideration in MM Docket No. 92-266.⁵⁰² This rule should apply, they assert, for purposes of setting rates under both the cost of service and the benchmark approach. These commenters argue that application of the prevailing market approach would retain all of the benefits inherent in vertical integration, but would still ensure that costs are market-based and not artificially inflated.

255. NCTA states that affiliate transaction rules for cable are not necessary at this time. NCTA claims that, unlike telephone companies, cable operators generally are not affiliated with vendors of equipment and other items except programming.⁵⁰³ NCTA also states that there is no history of cable operator cross-subsidization and no evidence that such is to be expected. If a pattern of problems does develop, the Commission can adopt narrow rules to address the abuses, according to NCTA.

256. Bell Atlantic states that cable operators should be required to record affiliate transactions according to the same rules that apply to telephone companies.⁵⁰⁴ The need to prevent operators from shifting profits upstream by paying inflated prices to programming affiliates is heightened, Bell Atlantic claims, by the Commission's ruling that affiliate programming costs are external costs that can be passed through to subscribers. Bell Atlantic further observes that cable operators acknowledge that they are upgrading their systems to provide

⁵⁰¹ Small Cities Comments at 34; see also Time Warner Comments at 39-40.

⁵⁰² Cablevision Industries Reply at 7-8; Viacom Reply at 14-15 (contending that in allowing the limited pass through of affiliated programming costs in that proceeding, the Commission concluded that those costs should not be deemed unreasonable per se, but should be compared to prevailing company prices or fair market value).

⁵⁰³ NCTA Comments at 42.

⁵⁰⁴ Bell Atlantic Comments at 16-17. These rules are codified at 47 C.F.R. §32.27. Bell Atlantic responds to cable operator objections that there is no evidence of abuse by cable operators, by arguing that such rules are not intended to be punitive but are designed to ensure that excessive payments to affiliates are not used to justify excessive rates.

telephone and other advanced services, not just cable services. Bell Atlantic claims that as long as cable operators are not covered by the rules that apply to telephone common carriers, cable operators will be free to use revenues extracted from their regulated cable customers to pay for the improvements to provide telephone services. Requests to delay implementation of affiliate transaction rules, Bell Atlantic maintains, are transparent efforts to preserve cable's existing competitive advantage.⁵⁰⁵

257. BellSouth argues that cable operators should be allowed to record affiliate transactions at the prices affiliates charge third parties. Otherwise, BellSouth states, the transactions should be recorded at the selling affiliates' fully distributed costs.⁵⁰⁶ GTE also proposes that cable operators be subject to the same affiliate transactions rules as telephone companies, but recommends that the rules currently applicable to telephone companies be amended to allow all affiliate transactions to be recorded at fair market value.⁵⁰⁷

258. New Jersey claims that cable operators should record affiliate transactions in accordance with GAAP and that the burden of proof for affiliate prices should rest with the operators who have the relevant data.⁵⁰⁸ Seaford supports a market-based approach that derives the price from the providing affiliates' recent sales to third parties, rather than from estimated fair market value.⁵⁰⁹

259. Municipals, NATOA, and Muzak support application of the telephone company rules to cable.⁵¹⁰ Additionally, NATOA responds to those who claim that affiliate transactions rules for cable are not necessary because there is no history of abuse. NATOA observes that, given the nature of cost-of-service showings and the preponderance of vertically integrated cable companies, cable operators will have an enormous incentive and opportunity

⁵⁰⁵ Bell Atlantic Comments at 17-18; Bell Atlantic Reply at 9-11.

⁵⁰⁶ BellSouth Comments at 25.

⁵⁰⁷ GTE Reply at 33-34.

⁵⁰⁸ New Jersey Comments at 10.

⁵⁰⁹ Seaford Comments at 30.

⁵¹⁰ Municipals Comments at 28; NATOA Comments at 13; NATOA Reply at 6-7; Muzak Comments at 7.

to show inflated costs wherever possible. NATOA claims that implementation of rules similar to those required of telephone companies would protect subscribers from paying rates based on "phantom higher costs" with a minimum burden on cable operators.

260. A number of commenters criticize our proposal to use a five percent ownership interest as the threshold for defining an affiliate.⁵¹¹ Some propose a twenty percent threshold, consistent with GAAP.⁵¹² BellSouth asserts that an affiliate relationship exists when an entity is controlled by, or is under common control with, another entity.⁵¹³ Likewise, GTE observes that the five percent standard is too burdensome and recommends a twenty percent threshold.⁵¹⁴ Michigan Committee, however, supports the five percent rule, and maintains that the same standard is used for cellular and other common carrier services.⁵¹⁵

iii. Discussion

261. In enacting the Cable Act of 1992, Congress intended to ensure that consumers pay reasonable rates for regulated cable

⁵¹¹ See, e.g., BellSouth Comments at 24; Arthur Andersen Comments at 37; GTE Comments at 25; GTE Reply at 33-34.

⁵¹² See, e.g., GTE Comments at 25; GTE Reply at 3-34. In instances of "significant influence," GAAP provides for special accounting for investments in affiliates using what is called the "equity method." This method requires adjustments to earnings to eliminate intercompany gains and losses from consolidated financial statements. Significant influence is assumed where and only where there is twenty percent or more ownership in the investment company, but the presumption can be overcome by predominant evidence to the contrary, i.e., that significant influence exists at a lesser level or that significant influence does not exist at or above the twenty percent threshold. See *The Equity Method of Accounting for Investments in Common Stock, Opinions of the Accounting Principles Board No. 18* (New York: AICPA, 1971); *Criteria for Applying the Equity Method of Accounting for Investments in Common Stock, Interpretations of the Financial Accounting Standards Board No. 35* (Stamford, Conn.: FASB, 1981).

⁵¹³ BellSouth Comments at 24.

⁵¹⁴ Arthur Andersen Comments at 37; BellSouth Comments at 25; GTE Comments at 25; GTE Reply at 33-34.

⁵¹⁵ Michigan Committee Comments at 21.

service.⁵¹⁶ We find that it would be inconsistent with this Congressional intent if we were to allow the rates for regulated cable service to reflect the prices affiliates charge each other for transactions that occur at other than arm's length. As we observed in proposing to strengthen our affiliate transactions rules for telephone companies, companies that are able to pass increases in their costs on to ratepayers may be motivated to pay excessive amounts for assets and services obtained from nonregulated affiliates.⁵¹⁷ In addition, companies may also have incentives to undercharge their nonregulated affiliates when the undercharges can be offset by increased charges to ratepayers.⁵¹⁸

262. Therefore, we will adopt rules for affiliate transactions⁵¹⁹ that will apply to cable operators who either

⁵¹⁶ See Cable Act of 1992, Sections 623(b), (c), codified at 47 U.S.C. § 543(b), (c).

⁵¹⁷ Amendment of Parts 32 and 64 of the Commission's Rules to Account for Transactions between Carriers and Their Nonregulated Affiliates, Notice of Propose Rulemaking, CC Docket No. 93-251, 8 FCC Rcd 8071 (1993) (Telco Affiliate Transactions Notice).

⁵¹⁸ Id. We do not agree with those commenters who suggest that it is not necessary to adopt affiliate transaction rules because there is no history of cross-subsidization in the cable industry. See TCI Comments at 58-59; NCTA Comments at 42. We find that affiliate transactions rules are justified where, as here, there is a potential for cross-subsidization.

⁵¹⁹ See 47 C.F.R. § 924(i) in Attachment B herein. We are proposing modifications to these rules in the Further Notice, however, in order to consider applying to cable system operators the changes that we have proposed to the valuation methods for affiliate transactions that involve telephone companies. In the Telco Notice, we analyzed in detail the specific methods for valuing transactions between telephone companies and their affiliates: prevailing company pricing, estimated fair market value, and cost. We tentatively concluded in the Telco Notice that we should sharply curtail prevailing company pricing for transactions between telephone companies and their nonregulated affiliates. We also tentatively concluded that we should require telephone companies to value affiliate transactions for which we do not permit prevailing company pricing at the higher of cost and estimated fair market value when the telephone company is the seller, and at the lower of cost and estimated fair market value when the telephone company is the buyer. We believe that it may be in the public interest to apply to cable system operators the

elect cost-of-service regulation or seek to adjust benchmark/price cap rates for affiliated programming costs.⁵²⁰ Under the rules we are adopting with this Report and Order, cable operators that elect cost-of-service regulation or who seek to adjust benchmark/price cap rates for affiliated programming costs shall be required to apply valuation methods that are similar to those telephone companies are now required to apply.⁵²¹ These methods distinguish between asset transfers and the provision of services.

263. When a cable operator sells assets to an affiliate or buys assets from an affiliate, the assets shall be valued at the asset provider's prevailing company price, if the provider has sold the same kind of asset to a substantial number of third

changes we have proposed for telephone companies and we, therefore, invite comment in the Further Notice on whether we should adopt affiliate transactions rules for cable similar to those we proposed for telephone companies.

⁵²⁰ It should be noted that, for those operators electing to use our benchmark/price cap approach, the affiliate transaction rules will only be applicable to affiliate transactions involving programming. In Docket No. 92-266, we determined that, under price caps, cable operators may pass-through affiliated programming costs that exceed inflation as long as the prices charged to the affiliated cable system operators reflect either prevailing company prices offered in the marketplace to third parties (where the affiliated program supplier has established such prices) or the fair market value of programming. First Order on Reconsideration at ¶ 114. We also stated that we would further examine this issue in the cost-of-service proceeding.

⁵²¹ It should be noted, however, that while the rules for telephone companies specify the manner of accounting for affiliate transactions, the affiliate transaction rules we are adopting for cable operators with this Report and Order do not impose accounting requirements. The affiliate transaction rules that we are adopting with this Report and Order merely set the limits for inclusion of investment and expense in rates set on a cost-of-service basis. They will also govern external cost treatment of programming cable operators purchase from affiliates.

Our proposal in Attachment C for an accounting system, however, proposes accounting requirements for affiliate transactions. The Further Notice seeks comment on all aspects of Attachment C, including the proposed requirements for affiliate transactions.

parties at a generally available price. Absent a prevailing company price, the cable operator shall value the asset at the higher of net book cost and estimated fair market value when the regulated cable system is the seller, and at the lower of net book cost and estimated fair market value when the regulated cable system is the buyer.

264. When a cable operator sells services to an affiliate or buys services from an affiliate, the services shall be valued at the provider's prevailing company price, if the provider has sold the same kind of service to a substantial number of third parties at a generally available price. When the provider has established no prevailing company price, the cable operator must value the service at the service provider's cost.

265. In determining the prevailing company price, we require that it be based on the price at which the provider has sold the same kind of asset or service to a substantial number of third parties at a generally available price. We do not adopt our proposal that an offer to sell will be sufficient to establish a prevailing company price because the price at which a company offers to sell a product or service to a third party will not necessarily reflect the price a third party would be willing to pay for an asset or service. We anticipate that affiliate transactions will usually be set at the prevailing company price, because the record indicates that affiliate transactions in the cable industry primarily involve purchases from affiliated programmers who sell the same products to third parties.⁵²²

266. In determining the cost of both assets and services, cable operators shall apply the costing methods and the rate of return this Order adopts for cable cost-of-service showings, to the extent applicable, and shall otherwise use reasonable costing methods. Where there is no prevailing company price, affiliate transactions must be carefully scrutinized to ensure that costs are calculated accurately and, for asset transfers, that fair market value is estimated properly. Therefore, cable operators must be prepared to demonstrate that any affiliated transactions costs they claim as regulated costs reflect the cost-of-service methodologies we adopt with this Report and Order.

267. For the purpose of evaluating affiliate transactions that involve programming, we shall classify programming as an

⁵²² NCTA states that, unlike telephone companies, the cable operators generally are not affiliated with vendors of equipment and other items except programming. NCTA Comments at 42. TCI states all affiliated programmers offer and sell their products to third parties. TCI Comments at 58-59.

asset. Hence, for the purpose of establishing initial costs for programming purchased by a cable operator from an affiliate, the cost of the programming shall equal the provider's prevailing company price, if the provider has sold the same kind of programming to a substantial number of third parties at a generally available price. Absent a prevailing company price, the cost of the programming shall equal the lower of the provider's net book cost and the programming's estimated fair market value.

268. Except to the extent that they are relevant for estimating fair market value, we will not allow the establishment of affiliate prices by reference to the prices independent suppliers charge third parties for the same or similar products. The difficulty of establishing comparability of assets, products, and services creates an inherent problem for a methodology that bases affiliate prices on prices that independent suppliers charge to third parties. This is particularly the case when the product is programming. What may appear comparable from a production viewpoint, for example, may in no way be comparable from the perspective of the program viewer. Thus, a low-cost production that provides the producer with a high price on the basis of high viewer demand may not be comparable to a similarly low-cost production with little viewer demand.

269. We will apply our rules adopted in the program access proceeding to define affiliated programmers.⁵²³ Under those rules, an affiliated programmer is a programmer with an ownership interest of five percent or more, including general partnership interests, direct ownership interests, and stock interests in a corporation where such stockholders are officers or directors or who directly or indirectly own five percent or more of the outstanding stock, whether voting or nonvoting. Such interests include limited partnership interests of five percent.

270. We find that a five percent ownership interest provides a reasonable threshold because it ensures that affiliate transaction rules do not apply where the ownership arrangement between a cable operator and another company is de minimis. At the same time, it ensures that affiliate transaction rules apply where there is clear potential for cross-subsidization. Accordingly, we do not agree with those parties who suggest that

⁵²³ See Rate Order, 8 FCC Rcd at 5788, n.601, citing Implementation of Sections 12 and 19 of the Cable Television Consumer Protection and Competition and Diversity Act of 1992 - Development of Competition and Diversity in Video Programming Distribution and Carriage, Report and Order, FCC 93-178, released April 30, 1993; 47 C.F.R. § 76.1000(b).

a 20 percent threshold is appropriate.⁵²⁴ We find that 20 percent ownership exceeds the minimum level at which a cable operator and an affiliate may have an incentive to engage in cross-subsidization. We find that the issue is not whether the cable operator controls the affiliate, the affiliate controls the cable operator, or the cable operator and the affiliate are under common control; the issue is whether an affiliate relationship is significant enough to create a possible incentive for cross-subsidization.⁵²⁵

271. Finally, we expect cable operators to provide detailed disclosure of affiliate transactions so that the Commission and franchising authorities can ensure that affiliate transactions are treated in a manner consistent with the limits of this Report and Order. Where cable operators have not demonstrated that their affiliate transactions meet the requirements of our affiliate transaction rules, disallowances shall be made by the Commission and franchising authorities.

IX. Streamlined Filing and Review

A. Small Systems

i. Notice

272. In the Notice, we solicited comment on whether we should modify for small systems any proposed cost-of-service requirements, and if so, what modifications we should make.⁵²⁶ We specifically sought comment on whether we should adopt streamlined alternatives for small systems. We also asked whether small systems means systems serving 1,000 subscribers or fewer, whether or not these systems are controlled by large MSOs, or whether some other definition was more appropriate.

⁵²⁴ See, e.g., part III., supra.

⁵²⁵ For purposes of eligibility for transition relief, and administrative relief for small systems, we have established a 20 percent affiliation threshold. Benchmark Order at II.B.4.b. These thresholds were appropriate because we were concerned not with incentives for cross-subsidization, but with overall financial relationships that could make it inappropriate for the regulated system to be eligible for transition relief or administrative relief. A five percent limit would unnecessarily restrict eligibility for transition relief.

⁵²⁶ Notice at ¶¶ 76-78.

ii. Comments

273. Many of the commenters, stating that the proposed cost-of-service requirements do not reduce administrative burdens for small systems, suggest other methods for reducing such burdens. For example, some commenters propose more generous benchmarks. California would allow systems with 5,500 subscribers or less up to 20 percent flexibility with the benchmark formula before a cost-of-service showing is required.⁵²⁷ NY Commission argues that small systems and franchise authorities should be permitted to decide among per-channel benchmark rates for systems with fewer than 1,000 subscribers.⁵²⁸ NCTA would allow small systems to increase their rates to the benchmark cap and to pass through rebuild costs.⁵²⁹

274. Several commenters propose the creation of a special advisory group or program within the Commission that would develop an average cost schedule for small systems and assist them with cost-of-service showings.⁵³⁰ The SBA argues that we should require that large MSOs show administrative hardship in the operation of their small systems before they can join such a program.⁵³¹ Small Systems describes how its model forms could be used for small systems' cost-of-service showings.⁵³²

275. Other proposed methods for reducing the burden on small systems include: the establishment of a programming pool to equalize the purchase price between large and small, and urban

⁵²⁷ California Comments at 73-74.

⁵²⁸ NY Commission Comments at 4.

⁵²⁹ NCTA Comments at 33-34 (contending that pricing flexibility will help generate necessary capital, and noting that Congress and the Commission have long advocated special regulatory treatment to provide state-of-the-art technology to rural subscribers).

⁵³⁰ California Comments at 74; Small Cities Comments at 4; SBA Comments at 21-24; Small Cable Reply Comments at 32.

⁵³¹ SBA Comments at 24.

⁵³² See Small Systems Comments at 38-41, Exhibits 1 and 2 for a detailed description of the cost-of-service models developed by Small Systems' consultant, Anthony Kern of Arthur Anderson & Company. These forms allow small systems to input various components of the ratemaking formula, i.e., operating expenses, ratebase, and rate of return.

and rural, systems;⁵³³ providing subsidies and revenue supports to small systems akin to those provided by Congress, the Commission, and state regulators to rural telephone companies for their high costs;⁵³⁴ adoption of a simplified accounting approach similar to Class B telephone company accounts;⁵³⁵ the negotiation of basic service rates;⁵³⁶ the adoption of a simple income statement approach;⁵³⁷ and the establishment of a liberal waiver policy for provisions imposing undue costs or burdens on small systems.⁵³⁸

276. Several parties comment on the feasibility of the proposed general streamlined measures for small systems' cost-of-service showings.⁵³⁹ SBA supports the benchmark plus significant capital improvement approach.⁵⁴⁰ Some commenters emphasize that the key to streamlining cost-of-service showings for small systems is to identify the unique characteristics and costs associated with such systems, *i.e.*, higher costs for capital, wiring, and programming.⁵⁴¹ SBA opposes the 1986 adjusted rate approach for small systems, arguing that the 1986 rates resulted

⁵³³ Small Cities Comments at 7.

⁵³⁴ *Id.* at 8.

⁵³⁵ BellSouth Comments at 32.

⁵³⁶ NTCA Comments at 2-3; NY Commission Comments at 3.

⁵³⁷ Tele-media Comments at 19.

⁵³⁸ NTCA Comments at 3.

⁵³⁹ Austin Comments at 14; SBA Comments at 19-24; BellSouth Comments at 32; Small Cable Reply Comments at 4, 28.

⁵⁴⁰ SBA Comments at 20-21 (arguing that such an approach is necessary for small systems to stay competitive with other multichannel video delivery systems, to satisfy customers' desires, and to include rural Americans in the telecommunications infrastructure of the next century); see also Small Cities Comments at 32-33.

⁵⁴¹ SBA Comments at 19-20; Small Cable Reply at 32-33. Although these commenters do not specify whether such factors should be added to the benchmark formula, they do support a simplified showing which includes these costs.

from franchise bidding wars and did not reflect economic reality.⁵⁴² Small Cable supports the 1986 adjusted rates approach but with no productivity offset for small systems.⁵⁴³ Pegasus supports its safe harbor formula for small systems, contending that this formula allows small system operators to raise cost-based rates to a formula-derived level without full cost-of-service showings.⁵⁴⁴

iii. Discussion

277. The Cable Act of 1992 directs us to reduce the administrative burdens of, and costs of compliance with, our cable regulations for small cable systems.⁵⁴⁵ We are adopting an abbreviated cost of service form for use by small systems. We believe this will reduce the administrative burdens of cost showings for small system operators, while retaining the necessary regulatory oversight and assurance of reasonable rates. We will require that the information provided on the abbreviated cost of service form be certified by the operator as correct; it will be subject to audit by the local franchising authority and by the Commission.

278. Consistent with our eligibility standards for small system administrative relief, independent small systems and small systems operated by small MSO's may use this form.⁵⁴⁶ Small MSO's are those multiple system operators that (1) serve 250,000 or fewer subscribers, (2) own only small systems with less than 10,000 subscribers, and (3) have an average system size of 1,000 or fewer subscribers. This is the same standard of eligibility that we adopt for other small system administrative relief.⁵⁴⁷

⁵⁴² SBA Comments at 17-18. SBA also contends that the 1986 rates do not reflect the technological advances and rebuilds of systems.

⁵⁴³ Small Cable Reply Comments at 31-32.

⁵⁴⁴ Pegasus Reply at 4-7. Pegasus urges that the formula combines the FCC-determined values for operating expense per customer, technical costs per cable mile, plant cost per mile, headend cost per channel and life of plant with the system operator's actual number of subscribers, plant miles, remaining life of plant, and number of regulated channels to determine the revenue requirement per channel.

⁵⁴⁵ 47 U.S.C § 623(i).

⁵⁴⁶ Benchmark Order at II.D.1.

⁵⁴⁷ See Benchmark Order at II.D.1.

Use of this form will not be available for small operators affiliated with larger systems.⁵⁴⁸

279. While we believe that all cable companies that choose to make cost-of-service filings should be subject to the uniform accounting requirements we propose here, at least in abbreviated form, we acknowledge commenters' argument that such accounting requirements may increase the administrative burden on small operators to the point of hardship, and that small operators are unlikely to require the same level of regulatory oversight as larger entities. Thus, in our Further Notice, we solicit comment on whether we should exempt small systems and/or small operators from these requirements entirely. We also adopt reduced accounting requirements for small systems.⁵⁴⁹

B. Network Upgrades

i. Notice

280. In the Notice, we sought comment on establishing an abbreviated cost-of-service alternative for significant prospective capital expenditures used to improve the quality of service or to provide additional services.⁵⁵⁰ Under this approach, operators seeking to raise rates to recover the costs of a planned upgrade would submit only the costs of the upgrade instead of all current costs. If otherwise in accordance with cost-of-service requirements, the costs of the upgrade would then be added to the rates permitted under the benchmark and price cap approach to the extent these costs could not be recovered under that approach. We stated that any cost recovery must comply with our cost allocation requirements, to ensure that only the costs allocable to regulated services are imposed on subscribers to

⁵⁴⁸ We adopt the same affiliation standards that we employ for small system administrative relief generally. We will not permit use of the small system relief form by companies in which a larger company holds more than a 20 percent equity interest (active or passive) or over which a larger company exercises actual working control (such as through a general partnership or majority voting shareholder interest). See Benchmark Order at II.B.4.b. This affiliated standard will also govern eligibility for the use of the abbreviated summary level accounts for small systems.

⁵⁴⁹ See Accounting Requirements, part V. supra.

⁵⁵⁰ Notice at ¶¶ 72-73.

those services.⁵⁵¹

ii. Comments

281. Cable operators commenting on this approach generally express a preference for passing through the cost of system upgrades as external costs.⁵⁵² They indicate, however, that in the alternative, an abbreviated approach would be acceptable.⁵⁵³ Comcast, for example, states that if the Commission decides not to permit system improvement costs to be passed through, it should adopt a "middle tier" or "abbreviated" showing for operators to justify the costs associated with system upgrades that would not discourage operators from investing in newer technologies to improve service to customers.⁵⁵⁴ Georgia Cable strongly supports an abbreviated approach, based on its observation that the benchmark and price cap framework does not include system upgrades and service improvements. It agrees with the Commission's proposal to add the cost of an upgrade to the benchmark rate subject to the cost allocation rules adopted by the Commission.⁵⁵⁵

282. NATOA supports the objective of an abbreviated cost-of-service showing for significant prospective capital expenditures, but not in the form proposed, which it believes has a number of pitfalls. The most serious difficulty, according to NATOA, is that the proposed approach does not take into account the possibility that operators are unable to recover upgrade costs because the operators are inefficient or because the costs are frivolous or otherwise unjustified.⁵⁵⁶ Local governments state that they might support this approach, but only for rates that will not be effective until the system upgrade is completed

⁵⁵¹ Notice at ¶ 75.

⁵⁵² See, e.g., Medium Operators Comments at 12; Continental Comments at 94.

⁵⁵³ See, e.g., COA Comments at 101; TMC Comments at 19; Small Cities Comments at 36; NCTA Comments at 36; Comcast Comments at 42-43; Georgia Cable Comments at 38; see also Corning Reply Comments at 6.

⁵⁵⁴ Comcast Comments at 42-43.

⁵⁵⁵ Georgia Cable Comments at 38; Corning Reply Comments at 6.

⁵⁵⁶ NATOA Comments at 4, 15. NATOA believes the proposal requires significant further study to ensure it is not abused.

and operational.⁵⁵⁷

283. BellSouth opposes a capital improvement add-on for four reasons. First, it believes that benchmark rates already reflect the rapid capital recovery employed by the cable industry in an unregulated environment, thereby providing cash flow to cable operators to reinvest in system upgrades; second, it asserts that most system upgrades should be recovered through depreciation expenses; third, it argues that competitive parity requires that depreciation expense for cable operators be treated as it is in the local telephone exchange carrier price cap plan, as an "endogenous" cost included in the benchmark; and fourth, it concludes that the cost-of-service approach would not provide significant administrative savings because it would require regulators to examine not simply the cost of the upgrades, but also the benefit to the cable operator in the form of reduced expenses and additional revenues.⁵⁵⁸

284. In reply, Corning endorses the abbreviated filing approach. It contends that the benchmark/price cap mechanism would typically fail to permit the full recovery of capital investment in upgrades and rebuilds, and that the streamlined cost-of-service mechanism would appear to offer the only means by which the Commission can spare regulators and cable operators the burden of full cost-of-service proceedings every time an operator wishes to rebuild or upgrade its system.⁵⁵⁹

iii. Discussion

285. We conclude that an abbreviated cost-of-service showing for network upgrades, with safeguards, provides an appropriate way to implement the goals of the Cable Act of 1992, to promote the availability of diverse cable services and facilities, encourage economically justified upgrades, and reduce

⁵⁵⁷ Utah Comments at 24; Michigan Comments at 24 (both asserting that the operator should not be able to increase its rates until the improvement is providing a benefit to subscribers).

⁵⁵⁸ BellSouth Comments at 30-31.

⁵⁵⁹ Corning Reply at 4-8. Corning suggests that an add-on to per-channel rates could be calculated based on the incremental cash flow necessary to support the upgrade and the cost of capital to finance the investment, including a reasonable rate of return. The cable operator would be obligated to present its underlying calculations and rationale to the reviewing body upon request.

regulatory burdens, while ensuring reasonable rates for regulated services.

286. For many systems, this option will be unnecessary or inapplicable. The benchmark/price cap mechanism is already based on the rates of competitive systems, including those with upgraded networks. The rates charged by those systems presumably recover their capital costs. The benchmark also includes factors reflecting the number of channels a system furnishes to customers. Nevertheless, there may be cases where the benchmark rates do not provide sufficient revenue to attract capital for upgrades because of unusual costs associated with capital improvements. For these cases the abbreviated cost-of-service showing should provide the ability to attract the capital needed for the upgrade.

287. While we understand NATOA's and BellSouth's concerns that the abbreviated approach might be abused or that the add-on rate might not be needed, we believe these concerns can be addressed while still expediting rate increases needed to pay for worthwhile upgrades. First, this option will be available only for significant upgrades requiring added capital investment, such as expansion of band width capacity and conversion to fiber optics, and for system rebuilds. Normal improvements and expansions of service will remain subject to the usual rate review process. Second, to justify an increase in the rates for regulated services, the operator will be required to demonstrate that the capital investment actually will benefit subscribers through improvements in the regulated services subject to the rate increase. This requirement will help assure that operators do not abuse the abbreviated filing option by requiring regulated service customers to pay higher rates to fund upgrades that actually only benefit other services.

288. Third, as suggested by the Municipalities, we agree that, except to the extent provided by our AFUDC policy, the upgrade rate increase should not be assessed on customers until the upgrade is complete and providing these benefits to customers of the regulated services. This is consistent with the general cost-of-service standard that only used and useful property should be included in the ratebase. Any costs that are not used and useful, such as the frivolous or inefficiently incurred costs cited by NATOA, will be deducted from total cost. We anticipate that issues of allowable costs can be resolved if raised by comparison with costs of similar systems and, in particular, systems subject to competition.

289. Fourth, to assure that the upgrade rate increase is justified by higher costs, the operator will bear the burden of demonstrating the amount of the net increase in costs, taking

into account current depreciation expense, likely changes in maintenance and other costs, changes in revenues, and expected economies of scale. And fifth, as we said in the Notice, the operator must also allocate the net increase in costs in conformance with the cost allocation rules for cost-of-service showings, to assure that only costs allocable to regulated services are imposed on subscribers to those services.

290. Based upon this showing of the net increase in allowable costs associated with the capital improvement, the operator would be permitted to set a rate based on two elements. The first element is the benchmark rate, as governed by the Rate Order and the price cap. The second element will be the capital improvement add-on. The sum of these two elements will yield the maximum allowable rate that might be charged to subscribers. The capital improvement add-on will not be adjusted for inflation but will be a fee charged over the useful life of the improvement determined in accordance with our cost-of-service requirements.

291. As part of our collection of forms for operators' cost-of-service showings, we will also develop forms for the abbreviated showings associated with network upgrades. We delegate to the Cable Services Bureau the development of appropriate forms for these abbreviated showings.

X. Hardship Rate Relief for Operators

292. Some cable operators urge that to ensure the continued growth of the cable industry, while conforming with the Cable Act of 1992 and the Fifth Amendment, the cost-of-service rules must be tailored to the economic and financial requirements of that industry.⁵⁶⁰ We believe that the combination of the benchmark/price cap mechanism with the cost-of-service backstop will in fact provide a workable and effective approach that recognizes both the requirements of the industry and the rights of customers, especially in combination with the abbreviated filing option, experimental incentive plan, and average cost approaches we have established or are seeking to develop. Thus, we believe our rules respond to these concerns. Nonetheless, we also recognize that, in extraordinary cases, the cable industry may face special problems as it moves into a regulated environment, and that it is conceivable that the particular circumstances of an operator could be such that the practical result of applying any of these rate options could still be to threaten the financial health of the operator and its continued ability to provide cable service.

⁵⁶⁰ See, e.g., Cablevision Systems Comments at 4-18.